

IN THE COURT OF APPEALS OF TENNESSEE  
AT NASHVILLE  
July 9, 2009 Session

**BLUE BELL CREAMERIES, L.P. v. LOREN CHUMLEY,  
COMMISSIONER DEPARTMENT OF REVENUE, STATE OF  
TENNESSEE**

**Appeal from the Chancery Court for Davidson County  
No. 06-414-III Ellen Hobbs Lyle, Chancellor**

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**No. M2009-00255-COA-R3-CV - Filed September 29, 2009**

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The Tennessee Department of Revenue assessed an excise tax on a nondomiciliary subsidiary corporation which conducted business in the state based on income earned outside the state as a result of the parent corporation's redemption of outstanding stock held by the subsidiary. The Department's tax assessment was based on a determination that the income was taxable as "business earnings" under the Tennessee Excise Tax Law. The trial court found that the subsidiary and its parent corporation were not part of a unitary business relationship and, consequently, that the tax assessment was unconstitutional. Finding that the entities were not part of a unitary business relationship, the judgment of the trial court is affirmed.

**Tenn. R. App. P. 3 Appeal as of Right; Judgment of the Chancery Court Affirmed**

RICHARD H. DINKINS, J., delivered the opinion of the court, in which ROBERT W. WEDEMEYER, J., joined. PATRICIA J. COTTRELL, P. J., M.S., not participating.

Robert E. Cooper, Jr., Attorney General and Reporter, Michael E. Moore, Solicitor General, and Brad H. Buchanan, Assistant Attorney General, for the appellant, the Commissioner of the Tennessee Department of Revenue.

James C. Bradshaw, III, Nashville, Tennessee, for the appellee, Blue Bell Creameries, L.P.

**OPINION**

In this case, we are called upon to determine whether the capital gain realized by a subsidiary entity as a result of a parent corporation's redemption of outstanding stock held by the subsidiary entity was subject to Tennessee's excise tax. We hold that the subsidiary and the parent corporation were not part of a unitary business relationship and, consequently, the tax assessment was unconstitutional.

## I. Background

Taxpayer, a limited partnership domiciled in Texas, was formed in November 2000 by Blue Bell Creameries, USA (“BBC USA”) as part of a corporate reorganization. Prior to the reorganization, Taxpayer’s predecessor, a limited partnership in which Blue Bell Creameries, Inc. was general partner with a 1% interest and BBC Limited Partner, Inc. was limited partner with a 99% interest, was engaged in the business of producing, selling and distributing ice cream in multiple jurisdictions (the “Business”), including Tennessee. BBC USA was a Delaware corporation serving as a holding company and parent corporation of Taxpayer’s predecessor; BBC USA indirectly owned 100% of Blue Bell Creameries, Inc., and directly owned 100% of BBC Limited Partner, Inc.

In November of 2000, BBC USA formed Taxpayer for the purpose of assuming the Business operated by its predecessor.<sup>1</sup> BBC USA’s wholly owned subsidiaries and Taxpayer’s predecessor contributed their assets to Taxpayer, after which Taxpayer’s predecessor was liquidated into BBC Limited Partner, Inc. In addition, Blue Bell General Partner, Inc., was formed to be a general partner of Taxpayer.

As part of the reorganization, BBC USA became an “S corporation,” thereby permitting 75 of its shareholders to exchange their BBC USA shares for an equal number of shares in the S corporation.<sup>2</sup> Certain eligible BBC USA shareholders not receiving shares in the S corporation were afforded the opportunity to contribute their BBC USA shares to Taxpayer in exchange for a limited partnership interest in Taxpayer.<sup>3</sup> Lastly, BBC USA’s remaining shareholders, who did not receive shares in the S corporation or a limited partnership interest in Taxpayer, had their shares recapitalized, which converted their stock into a right to receive a lump sum cash payment.<sup>4</sup>

On January 1, 2001, the majority of BBC USA’s shareholders contributed their BBC USA stock to Taxpayer in exchange for a limited partnership interest in Taxpayer. The same day, BBC

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<sup>1</sup> When it was formed, Taxpayer was named Blue Bell Operating, L.P. After reorganization, Taxpayer’s name was changed to its current name, Blue Bell Creameries, L.P., the same name held by its predecessor.

<sup>2</sup> Subchapter S of the Internal Revenue Code permits eligible small business corporations to elect to be organized as an “S corporation” for the purpose of seeking the preferential tax treatment established for such entities under the subchapter. *See generally* 26 U.S.C. § 1361, *et. seq.* At the time of the reorganization, an S corporation was statutorily limited to no more than 75 shareholders. 26 U.S.C. § 1361 (2001). The current statute, effective May 25, 2007, allows an S corporation to have no more than 100 shareholders. 26 U.S.C. § 1361 (2007).

<sup>3</sup> The record does not show what the eligibility criteria were.

<sup>4</sup> According to BBC USA’s Second Amended and Restated Plan of Reorganization, the “Recapitalization” resulted in “each Ineligible Stockholder [receiving] an amount...equal to \$195,000 for its shares.”

USA redeemed the stock which had been contributed to Taxpayer in exchange for a cash payment of \$142,506,000.00; this redemption resulted in a capital gain of \$119,909,317.00 to Taxpayer.<sup>5</sup>

In its 2001 Tennessee Franchise and Excise Tax Return, Taxpayer classified the capital gain realized from the January 1 stock redemption as “nonbusiness earnings.” At some point, the Tennessee Department of Revenue (“Department”) determined that the capital gain was a “business earning” and that it should have been included in Taxpayer’s apportionable income subject to the State’s excise tax. Taxpayer filed an objection with the Department, which was denied on May 20, 2005. On August 31, 2005, Taxpayer paid the Department \$146,025.25, which accounted for unpaid amounts owed, plus interest and penalties, as of August of 2005.<sup>6</sup>

On February 14, 2006, Taxpayer filed suit against the Department, seeking a refund of \$128,407.00 for “all excise tax, interest, and penalties assessed by [the Department]...on the gain realized by [Taxpayer] in the redemption by BBC USA of its shares” and for “interest on any refund awarded.”<sup>7</sup> The Department filed an answer on March 20, 2006. Both parties subsequently filed motions for summary judgment and a hearing on the motions was held on August 1, 2008.

On August 15, 2008, the trial court issued a “Memorandum and Order,” which discussed both parties’ reliance on the “unitary business principle” to “analyze the connection between [Taxpayer’s] capital gains from the stock redemption and the business it regularly does in Tennessee.” The order directed the Department to file a supplemental brief to clarify the “functional integration” between Taxpayer and BBC USA and to explain “the concrete tax advantages and non-reporting and non-registering of securities advantages [Taxpayer] received from the stock redemption and where in the record these advantages are proven.” Taxpayer was given the opportunity to file a brief in reply.

On November 13, 2008, the trial court issued a Memorandum finding that the Department’s tax imposition was unconstitutional and that there were insufficient facts in the record to determine whether the capital gain was a “business earning.” On January 5, 2009, the trial court entered its order awarding Taxpayer a refund of \$164,779.07, as well as statutory interest; pursuant to Rule

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<sup>5</sup> After reorganization, the corporate structure included BBC USA, now an S corporation, as parent of the various entities; Blue Bell Creameries, Inc., formerly general partner of Taxpayer’s predecessor, whose role after the reorganization is not apparent in the record; BBC Limited Partner, Inc., limited partner of Taxpayer; Blue Bell General Partner, Inc., general partner of Taxpayer; and Taxpayer.

<sup>6</sup> Taxpayer’s \$146,025.26 payment to the Department included amounts not related to this matter and constituted an overpayment in the amount of \$48.63, which was applied to its future tax years.

<sup>7</sup> Pursuant to Tenn. Code Ann. § 61-1-1801, a taxpayer is required to file a refund claim with the Commissioner of Revenue before seeking a refund with the Chancery Court; the Commissioner, however, waived that requirement at Taxpayer’s request, as allowed by Tenn. Code Ann. § 67-1-1802(c)(2).

54.02, Tenn. R. Civ. P., the trial court directed the entry of a final judgment.<sup>8</sup> The Department appeals, raising the following issues:

1. Whether the income at issue is constitutionally apportionable and thus taxable as business earnings, when there is a unitary relationship between the payee-taxpayer, Taxpayer, and its holding company, BBC USA, in that everything done by each entity was orchestrated together to further the single ice cream business of which both are a part.
2. Whether the Chancery Court erred in holding that the record was insufficient for the court to conclude, as a matter of law, that the income at issue in this case constitutes “business earnings” under Tenn. Code Ann. § 67-4-2004(a)(1) (2000 Supp.), when the record establishes that Taxpayer acquired, used, and disposed of the income-producing property in a restructuring that was integral to the regular unitary business of which the taxpayer was a part.

## II. Standard of Review

The issues in the present matter were resolved in the trial court upon the parties’ cross-motions for summary judgment. Neither party contends on appeal that genuine issues of material fact exist regarding the trial court’s first holding that the imposition of the excise tax was unconstitutional. Summary judgment is appropriate if no genuine issues of material fact exist, and the movant meets its burden of proving that it is entitled to a judgment as a matter of law. *See* Tenn. R. Civ. P. 56.03; *Martin v. Norfolk Southern Ry. Co.*, 271 S.W.3d 76, 84 (Tenn. 2008). Therefore, our review of whether, under the undisputed facts, the tax imposition was constitutional is a matter of law. We take the strongest view of the evidence in favor of the nonmoving party, allowing all reasonable inferences in its favor and discarding all countervailing evidence. *See Shadrick v. Coker*, 963 S.W.2d 726, 731 (Tenn. 1998)(citing *Byrd v. Hall*, 847 S.W.2d 208, 210-11 (Tenn. 1993)). Since our review concerns questions of law, we review the record *de novo* with no presumption of correctness. *See* Tenn. R. App. P. 13(d); *Bain v. Wells*, 936 S.W.2d 618, 622 (Tenn. 1997). However, “[t]ax assessments are presumed to be valid” and “a taxpayer who challenges a...tax assessment must show by clear and convincing evidence that the...application of the apportionment formula has caused extraterritorial value to be taxed.” *Louis Dreyfus Corp. v. Huddleston*, 933 S.W.2d 460, 467 (Tenn. Ct. App. 1996).

## III. Analysis

The tax assessment at issue in this matter involves the Department’s application of the Tennessee excise tax to a portion of Taxpayer’s income earned outside the state. In order for the

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<sup>8</sup> Having determined that Taxpayer was the prevailing party and, thereby, entitled to an award of attorneys’ fees and expenses pursuant to Tenn. Code Ann. § 67-1-1803(d), the court reserved judgment on the amount of fees pending the resolution of appeals.

Department to tax out-of-state income, the tax assessment must be constitutional, pursuant to the Due Process and Commerce Clauses of the United States Constitution, *MeadWestvaco Corp. ex rel. Mead Corp. v. Illinois Dept. of Revenue*, 128 S.Ct. 1498, 1505 (U.S. 2008), and must seek to apportion income which constitutes “business earnings,” pursuant to Tennessee’s “Excise Tax Law.” See Tenn. Code Ann. § 67-4-2001, *et. seq.*

#### A. Constitutionality of the Tax Assessment

In its motion for summary judgment, the Department asserted that its taxation of the capital gains realized by Taxpayer from the stock redemption was “constitutionally permissible under the standard of unitariness required by the Due Process and Commerce Clauses of the United States Constitution” because Taxpayer’s acquisition, and BBC USA’s subsequent redemption, of the BBC USA stock were both “undertaken as a part of the unitary Business of which both [Taxpayer] and [BBC USA] were a part.”

In its response in opposition to the Department’s motion, Taxpayer asserted that the Department could not “legally levy a tax against the income of a multi-state corporation...[unless] the income [had] a substantial nexus to the business activities carried out by the taxpayer in the taxing state” and that “an extraordinary, one-time stock redemption transaction carried out by a holding company in Texas simply lacks sufficient nexus with [Taxpayer’s] production, sale, and distribution of ice cream in the state of Tennessee to justify imposition of a tax.”

The Due Process and Commerce Clauses “impose distinct but parallel limitations on a State’s power to tax out-of-state activities.” *MeadWestvaco Corp.*, 128 S.Ct. at 1505. “The principle that a State may not tax value earned outside its borders rests on the fundamental requirement of both the Due Process and Commerce Clauses that there be ‘some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.’” *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 777 (1992) (quoting *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 344-45 (1954)). “[I]n the case of a tax on an activity, there must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax.” *Id.* at 778.

“Where...there is no dispute that the taxpayer has done some business in the taxing State, the inquiry shifts from whether the State may tax to what it may tax.” *MeadWestvaco Corp.*, 128 S.Ct. at 1505. To answer that question, the United States Supreme Court developed the “unitary business principle,” *MeadWestvaco Corp.*, 128 S.Ct. at 1505, which is “at the heart of any formula to apportion corporate revenues for tax purposes.” *Louis Dreyfus Corp.*, 933 S.W.2d at 466. “Under th[e] principle, a State need not ‘isolate the intrastate income-producing activities from the rest of the business’ but ‘may tax an apportioned sum of the corporation’s multistate business if the business is unitary.’” *MeadWestvaco Corp.*, 128 S.Ct. at 1505 (quoting *Allied-Signal*, 504 U.S. at 772). “A unitary business is a business whose components are too closely connected and necessary to each other to justify division or separate consideration as independent units.” *Louis Dreyfus Corp.*, S.W.2d at 467. “In order to exclude certain income from the apportionment formula, the company must prove that “the income was earned in the course of activities unrelated to [those

carried out in the taxing] State.”” *Allied-Signal, Inc.*, 504 U.S. at 787 (quoting *Exxon Corp. v. Department of Revenue of Wis.*, 447 U.S. 207, 223 (1980), in turn quoting *Mobil Oil Corp. v. Comm’r of Taxes of Vt.*, 445 U.S. 425, 439 (1980)). “Thus, the pivotal question in cases such as this one is whether the business income sought to be included in the apportionable tax base derives from an unrelated business activity constituting a discrete business enterprise that is not part of the taxpayer’s unitary business.” *Louis Dreyfus Corp.*, 933 S.W.2d at 466; *MeadWestvaco Corp.*, 128 S.Ct. at 1505.

Neither party disputes the fact that Taxpayer conducted business in Tennessee, thereby justifying the state’s ability to tax its earnings, *Newell Window Furnishing, Inc. v. Johnson*, 2008 WL 5169560, at \*5 (Tenn. Ct. App. Dec. 9, 2008) (citing *Allied-Signal, Inc.*, 504 U.S. at 778) (“where...a taxpayer has done business in the State, taxation is justified by the ‘protection, opportunities and benefits’ the State has conferred on the taxpayer’s activities within the State”), and shifting the inquiry to whether the Department was constitutionally permitted to impose a tax on the earnings at issue. *MeadWestvaco Corp.*, 128 S.Ct. at 1505.

“The courts have devised several tests for determining whether a business is unitary.” *Louis Dreyfus Corp.*, 933 S.W.2d at 468. The Department asserted that Taxpayer and BBC USA were unitary under either the “hallmarks of a unitary relationship” test or the operational function test; the trial court applied both tests in its determination as to whether the Department’s tax assessment of Taxpayer’s capital gains was constitutional.

#### 1. “Hallmarks of a Unitary Relationship” Test

The test that has been described as the “‘hallmarks’ of a unitary relationship” test focuses on the functional integration, centralization of management, and economies of scale between business components. *Allied-Signal*, 112 S.Ct. at 783; *MeadWestvaco Corp.*, 128 S.Ct. at 1508; *Louis Dreyfus Corp.*, 933 S.W.2d at 469-71. Under this test, the “factors that should be considered...are the extent of control and ownership that the various components of the business have over one another, the degree of functional integration or interrelationship/interdependence among the business’s operations, and the economies of scale.” *Newell*, 2008 WL 5169560, at \*6. “No single factor is controlling under any of the tests” and a court must “examine these factors in combination to determine whether the business is unitary.” *Louis Dreyfus Corp.*, 933 S.W.2d at 468. “[A] relevant question in the unitary business inquiry is whether ‘contributions to income [of the subsidiaries] result[ed] from functional integration, centralization of management, and economies of scale.’” *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 179 (1983) (quoting *F.W. Woolworth Co. v. Taxation and Revenue Dept. of State of N.M.*, 458 U.S. 354, (1982)).

In support of its motion for summary judgment, the Department relied upon the parties' pleadings; its Statement of Undisputed Material Facts<sup>9</sup>; the deposition of William J. Rankin, Blue Bell General Partner, Inc.'s Chief Financial Officer<sup>10</sup>; the affidavit of Terri McAllister, a tax auditor

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<sup>9</sup> In its Statement of Undisputed Material Facts, the Department made certain assertions of fact, to which Taxpayer provided the following responses, in part pertinent:

1. [BBC USA] prior to the transactions and events of November 2000 through January 1, 2001 (the "Reorganization"), was "a privately owned holding company which exist[ed] to own the assets and properties of the related businesses and legal entities that develop, make, sell and otherwise operate the business and products commonly known as 'Blue Bell Ice Cream' (hereinafter referred to collectively as the 'Business').

RESPONSE: Undisputed.

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10. Upon its formation, [Taxpayer] offered certain [BBC USA] stockholders the opportunity to exchange all of their [BBC USA] shares for an equal numbers [sic] of shares in the limited partnership interest of [Taxpayer]; about 250 shareholders accepted the offer and contributed 1,131 shares in exchange for approximately 29% of [Taxpayer's] partnership interests.

RESPONSE: Undisputed.

11. [BBC USA] purchased those of its shares held by [Taxpayer] "in a transaction considered to be a redemption of the affected shares (the 'Redemption')." The sole purpose of this redemption was to effectuate the Reorganization of the Business.

RESPONSE: Undisputed.

12. The Redemption price totaled \$142,506,000. It was determined by the [BBC USA] board of directors to reflect the stock's fair market value as appraised by outside consultants.

RESPONSE: Undisputed.

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17. The Redemption payment of \$142,506,000 from [BBC USA] to [Taxpayer] resulted in total capital gains of \$119,909,317, which was includable in [Taxpayer's] federal taxable income and which [Taxpayer] thus reported as taxable gains to the federal government.

RESPONSE: Undisputed.

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19. [Taxpayer's] acquisition of [BBC USA] stock from certain [BBC USA] stockholders was integral to the execution of the Business's Second Amended and Restated Plan of Reorganization.

RESPONSE: Undisputed.

20. The actual operation of the Business's ice cream business was controlled, managed, and conducted by [Taxpayer's predecessor] prior to Reorganization and by [Taxpayer] afterward.

RESPONSE: Undisputed.

21. [BBC USA] "was a holding company that did not conduct any business operations."

RESPONSE: Undisputed.

22. The Second Amended and Restated Plan of Reorganization was formulated and adopted centrally on behalf of all the entities within the Business.

RESPONSE: Undisputed.

<sup>10</sup> Attached as Exhibit No. 5 to Mr. Rankin's deposition was the Second Amended and Restated Plan of Reorganization, which contained the following provisions, in part pertinent:

2. **Purpose of the Plan.** [BBC USA's] board of directors desires to reorganize [BBC USA] so that it can remain a private company of an indefinite period of time, thereby avoiding the expense and inconvenience of registering its securities and publicly reporting its financial results and so that its

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employed by the Department, which discussed Taxpayer's tax liability under both parties' positions; Taxpayer's responses to the Department's first set of interrogatories<sup>11</sup> and document requests<sup>12</sup>; and Taxpayer's response to the Department's second set of interrogatories.<sup>13</sup>

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<sup>10</sup> (...continued)

stockholders may receive "pass through" tax treatment after effecting the transactions contemplated in this Second Amended and Restated Plan of Reorganization (the "Plan") by qualifying [BBC USA] or its successor, as an S corporation, as defined in [Internal Revenue] Code section 1361.

**3. Overview of Plan of Reorganization.** Pursuant to the Plan of Reorganization:

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c. [Taxpayer] will offer certain eligible [BBC USA] stockholders the opportunity to exchange all their currently owned [BBC USA] Shares for an equal number of LP Shares (the "LP Offering").

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e. [BBC USA] will purchase the [BBC USA] Shares held by [Taxpayer] as a result of the LP Offering in a transaction considered to be a redemption of the affected shares (the "Redemption"). [BBC USA] will pay a Redemption price determined by the [BBC USA] board of directors to be equivalent to the fair market value of the [BBC USA] Shares based on the advice of an independent valuation expert...The Redemption will be a taxable event for Federal income tax purposes and will cause *participants in the LP Offering* to pay Federal income tax based on the gain *they recognize* from the Redemption.

(Emphasis added).

<sup>11</sup> Taxpayer provided the following responses, in part pertinent, to interrogatories filed by the Department:

INTERROGATORY NO. 3: Identify and describe the business of the entity called [BBC USA] as of January 1, 2001, including all lines of business in which BBC USA was involved at the time, any and all subsidiaries of BBC USA at and around that time, and any ownership, contractual, organization, or other business relationship with [Taxpayer] at that time.

ANSWER: At January 1, 2001, [BBC USA] was a holding company. BBC USA held, either directly or indirectly, a 100% interest in Blue Bell Creameries [], Inc. . . . and BBC Limited Partner, Inc., . . . which were holding companies. BBC USA also held an indirect 100% interest in Blue Bell Creameries, Inc., the General Partner of [Taxpayer]. BBC USA indirectly held an approximately 70% interest in [Taxpayer], the operating company that manufactures and distributes Blue Bell Ice Cream and other frozen dessert products.

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INTERROGATORY NO. 7: Identify and describe the immediate action taken by [Taxpayer] with respect to [the capital gain from the stock redemption] once it was received by [Taxpayer], including specific accounts into which cash was deposited (and how much into each account, if more than one) as well as the immediate action taken by [Taxpayer] with respect to consideration received in non-cash forms.

ANSWER: \$94,106,645 was distributed by [Taxpayer] to the [Taxpayer] partners.

<sup>12</sup> The documents produced by Taxpayer, in part pertinent, included a list of the recipients of the \$94,106,645 distributed by Taxpayer, mentioned in Taxpayer's response to Interrogatory No. 7.

<sup>13</sup> Taxpayer provided the following response, in part pertinent, to the Department's second request for interrogatories:

INTERROGATORY NO. 1: Identify and explain the purpose of the redemption...from the perspective

(continued...)



In support of its motion for summary judgment, Taxpayer relied upon Mr. Rankin's affidavit<sup>14</sup> and deposition and its Statement of Uncontested Material Facts.<sup>15</sup>

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<sup>13</sup>(...continued)

of [Taxpayer and its predecessor], shareholders or partners of any member of the Blue Bell family of entities, and any other individuals or entities affected by the redemption.

ANSWER: The purpose of reorganization that took place on 12/13/2000-01/01/2001 was to reorganize [BBC USA] so that it could remain a private company for an indefinite period of time, thereby avoiding the expense and inconvenience of registering its securities and publicly reporting its financial results and so that its stockholders may receive "pass-through" tax treatment. Due to the limitation on the number of S Corporation shareholders allowed, the redemption was necessary to "move" individual shareholders from [BBC USA] to [Taxpayer].

<sup>14</sup> Mr. Rankin's affidavit included the followings averments, in part pertinent:

2. [Taxpayer] is in the business of producing, selling, and distributing ice cream both within and outside the state of Tennessee.

3. [BBC USA] is a holding company and does not conduct any business operations in Tennessee or elsewhere.

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8. [Taxpayer's] monetary holding of BBC USA stock and the redemption of the stock by BBC USA was a part of an extraordinary, one-time reorganization transaction of BBC USA and affiliates and not part of any ongoing business activity or trade of [Taxpayer].

9. [Taxpayer's] monetary holding of BBC USA shares and the redemption of those shares by BBC USA was not an integral part of [Taxpayer's] regular trade or business operations.

10. The shares of BBC USA stock were contributed to [Taxpayer] by individual shareholders of BBC USA, and the gain from the stock redemption was allocated to the individual shareholders of BBC USA because the appreciation occurred while the stock was held by the shareholders prior to contribution to [Taxpayer].

11. [Taxpayer's] momentary ownership of BBC USA stock did not serve any operational function or purpose for [Taxpayer] and did not in any way further [Taxpayer's] production, sale, or distribution of ice cream in the state of Tennessee.

<sup>15</sup> In its Statement of Uncontested Material Facts, Taxpayer made certain assertions of fact, to which the Department provided the following responses, in part pertinent:

7. On January 1, 2001, shortly after [Taxpayer's] acquisition of BBC USA stock by contribution, BBC USA redeemed its stock from [Taxpayer].

RESPONSE: Undisputed, presuming that "shortly after" means that the shares were redeemed later the same day.

8. [Taxpayer's] momentary holding of the BBC USA stock and the redemption of the stock by BBC USA was a part of an extraordinary, one-time reorganization transaction of BBC USA and affiliates and not part of any ongoing business activity or trade of [Taxpayer].

RESPONSE: Undisputed that the redemption was a part of an extraordinary, one-time reorganization transaction of BBC USA and affiliates. No response to remainder of the statement...is appropriate...as it presumes a legal conclusion and is thus a statement of law rather than a statement of fact...To the extent that the Court finds that a response to this portion of the statement is appropriate..., it is disputed as a matter of law because the redemption produced earnings which are business earnings for [Taxpayer] under the functional test.

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(continued...)

### *Centralization of Management*

As evidenced by Taxpayer's answer to the Department's Interrogatory No. 3, there is no dispute as to BBC USA's ownership of Taxpayer. "However, a business's choice of structure does not control whether a business is unitary." *Louis Dreyfus Corp.*, 933 S.W.2d at 469. The "unity of ownership alone does not necessarily indicate that the various components of a business are substantially interdependent on each other," but rather "[a] more significant inquiry concerns the control of the business' activities." *Id.* "This inquiry should consider not only the extent of centralized control of the business but also the existence and extent of control that the business' components have over the activities of the other components." *Id.*

In its response in opposition to Taxpayer's motion for summary judgment, the Department relied upon the fact that "[t]he Second Amended and Restated Plan of Reorganization was formulated and adopted centrally on behalf of all the entities" to evidence the "central management" of the related entities. While there is evidence of overlap in the management of the entities,<sup>15</sup> the record does not reflect sufficient control on the part of BBC USA over Taxpayer's activities in Tennessee to support a finding of centralized management. In fact, the Department's Statement of Undisputed Material Facts asserted that "[t]he actual operation of the...ice cream business was *controlled, managed, and conducted* by [Taxpayer's predecessor] prior to the Reorganization and by [Taxpayer] afterward" (emphasis added); this assertion was undisputed by Taxpayer. In the absence of evidence establishing BBC USA's control over Taxpayer's activities, we find that there was not centralized management of the entities for purposes of the hallmarks of a unitary relationship test.

### *Functional Integration*

For there to be functional integration between a business's components, "there must be a substantial interrelationship or interdependence among its basic operations." *Louis Dreyfus Corp.*, 933 S.W.2d at 469. "A business is unitary when the operation of one of its components depends upon and contributes to the operation of its other components." *Id.* at 467. "[A] unitary business may exist without a flow of goods between the parent and subsidiary, if instead there is a flow of value between the entities." *Allied-Signal*, 504 U.S. at 783. However, the "United States Supreme Court has recognized that one component may 'add to the riches' of the corporation and yet remain

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<sup>15</sup> (...continued)

10. The shares of BBC USA stock were contributed to [Taxpayer] by individual shareholders, and the gain from the stock redemption was allocated to the individual shareholders because the appreciation occurred while the stock was held by the shareholders prior to contribution to [Taxpayer]. RESPONSE: Undisputed that "the shares of BBC USA stock were contributed to [Taxpayer] by individual shareholders." With respect to the rest of the statement, the [Department] is unable to respond because the statement does not state for what purpose "the stock redemption was allocated to the individual shareholders."

<sup>16</sup> The Department cites the fact that Paul Kruse signed the Redemption Agreement in his capacities as Vice President of BBC USA and as Vice President of the general partner of Taxpayer.

a discrete business enterprise.” *Id.* at 470 (citing *ASARCO, Inc. v. Idaho State Tax Comm’n*, 458 U.S. 307, 328 (1982)).

In its response in opposition to Taxpayer’s motion for summary judgment, the Department contended that the reorganization was evidence of functional integration because it was done for the purpose of benefitting the entire Business, from the ice cream making operations to the shareholders. In making this assertion, the Department relied upon an undisputed statement made in its Statement of Undisputed Material Facts, in which it said:

7. The Reorganization which was carried out from November 2000 through January 1, 2001, was undertaken for the purpose of allowing [BBC USA] and *the Business as a whole to* remain a private company for an indefinite period of time, thereby avoiding the expense and inconvenience of registering its securities and publicly reporting its financial results and so that its stockholders may receive “pass through” tax treatment after effecting the transactions contemplated in this Second Amended and Restated Plan of Reorganization (the “Plan”) by qualifying [BBC USA] or its successor, as an S corporation, as defined in [Internal Revenue] Code section 1361.

(Emphasis added). In its Memorandum and Order, the trial court presumed that the language “the Business as a whole” included the Taxpayer, but questioned the benefits conferred upon Taxpayer by the reorganization because “the source for [the Department’s statement] [wa]s BBC USA’s Second Amended and Restated Plan of Reorganization” and “the actual text of the Plan of Reorganization...d[id] not state that the reorganization benefits the business as a whole,” but rather that “the benefits on the less reporting time inure to BBC USA and the tax advantages apply to its shareholders.”

Because of the above inconsistencies in the Department’s position, the trial court ordered the Department to file a brief “to assist the Court in analyzing the functional integration between [Taxpayer] and BBC USA” by “explaining the concrete tax advantages and non-reporting and non-registering of securities advantages [Taxpayer] received from the stock redemption and where in the record these advantages are proven.” In its final Memorandum, the court concluded that “[t]here is no statement in the Plan and, thus, no factual basis in the record for the claim that the advantages of the reorganization are benefits shared by the [Taxpayer]” and that the Department has not, “independent of the record, articulated any discreet [sic] or more than incidental advantage to [Taxpayer].”

Upon a review of the record available to this Court,<sup>17</sup> we agree with the trial court’s finding. Taxpayer’s response to the Department’s second request for interrogatories revealed that the

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<sup>17</sup> The Department’s supplement brief, if filed, cannot be found in the record.

“purpose of the reorganization...was to reorganize [BBC USA] so that it could remain a private company..., thereby avoiding the expense and inconvenience of registering its securities and publicly reporting its financial results and so that its stockholders may receive ‘pass through’ tax treatment.”<sup>18</sup> As for Taxpayer’s role in the reorganization, the Department acknowledged in its Statement of Undisputed Material Facts that “[t]he sole purpose of this redemption was to effectuate the Reorganization of the Business” and Taxpayer stated in its response to the Department’s second request for interrogatories that the stock redemption’s role in the reorganization was only “to ‘move’ individual shareholders from [BBC USA] to [Taxpayer].” The record does not contain sufficient evidence to prove that Taxpayer realized any benefits as a result of the reorganization or the stock redemption which contributed to Taxpayer’s operations or which Taxpayer depended on in performing its operations, *Louis Dreyfus Corp.*, 933 S.W.2d at 467, so as to justify a finding that BBC USA and Taxpayer were functionally integrated.

The Department also contends that BBC USA, as a pure holding company of Taxpayer, would “have no reason to exist” without Taxpayer’s operation and that the United States Supreme Court has “held that the ‘holding company function’ is *not* a discrete, separate business.” (Emphasis in original).

In making its assertion, the Department relied on the United States Supreme Court opinion in *Mobil Oil Corp. v. Comm’r of Taxes of Vt.*, 445 U.S. 425 (1980), in which that court addressed a taxpayer’s argument for the classification of a holding company as a separate business:

Nor do we find particularly persuasive Mobil’s attempt to identify a separate business in its holding company function. *So long as dividends from subsidiaries and affiliates reflect profits derived from a functionally integrated enterprise*, those dividends are income to the parent earned in a unitary business. One must look principally at the underlying activity, not at the form of investment, to determine the propriety of apportionability.

*Id.* at 440 (emphasis added). While we agree that the Court found that holding companies are not automatically separate businesses from their subsidiaries, we do not adopt the Department’s assertion that holding companies are *never* separate businesses; rather, to be unitary with its subsidiary, the income earned by a holding company must “derive[] from a functionally integrated enterprise.” The parties and the trial court agreed that Tennessee caselaw has not addressed functional integration in the context of holding companies; instead, the parties’ relied upon, and the trial court adopted, the analysis conducted by courts in other jurisdictions.

The court in *In the Matter of the Appeals of PBS Bldg. Sys., Inc., et. al.*, 1994 Cal. Tex. LEXIS 434 (Nov. 17, 1994) stated that “there is no...separate standard or higher burden of proof which holding companies must meet in order to be held unitary with operating subsidiaries” and that

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<sup>18</sup> In answering the interrogatory, Taxpayer relied upon the Second Amended and Restated Plan of Reorganization.

“where pure or passive holding companies are involved, it is relevant to carefully inquire into the nature of the benefits accruing on both the holding company and the operating subsidiaries as a result of their corporate structure.” *Id.* at \*7, \*13-14. In addressing the components of functional integration with a holding company, the court recognized that “flows of value or contribution and dependency may take the form of shared tax benefits..., intercompany financing (loans, loan guarantees and debt retirement) or improved credit worthiness (bond security, more favorable insurance rating or interest rates on borrowed capital).” *Id.* at \* 14.

The court in *A.B. Dick Co. v. McGraw*, 678 N.E.2d 1100 (Ill. App. Ct. 1997) held that “[t]he fact that a holding company owns controlling interest in several corporations is not enough to make the group a unitary business.” *Id.* at 1102 (citing *Mobil Oil Corp.*, 445 U.S. at 440). The court further stated that “[t]here must be something “beyond the mere flow of funds arising out of a passive investment or distinct business operation”” and that “[t]here must be more than the type of occasional oversight “that any parent gives to an investment in a subsidiary.”” *Id.* at 1102 (citing *Citizens Utilities v. Dep’t of Revenue*, 488 N.E.2d 984, 990 (Ill. 1986), in turn quoting *Container Corp.*, 463 U.S. at 166, and quoting *Container Corp.*, 463 U.S. at 180).

As was held in *Mobil Oil* and *PBS Bldg. Sys.*, functional integration must still be present in order for BBC USA, as a holding company, to be considered a single unitary business with Taxpayer, its subsidiary. As stated earlier, the Department acknowledged that “[t]he actual operation of the...ice cream business was controlled, managed, and conducted by [Taxpayer’s predecessor] prior to the Reorganization and by [Taxpayer] afterward” and that BBC USA “was a holding company that did not conduct any business operations.” Furthermore, as stated earlier, the reorganization was for the sole purpose of converting BBC USA into an S corporation so BBC USA and its remaining shareholders could obtain favorable tax treatment and avoid registering and reporting expenses; there is no evidence in the record that Taxpayer realized these benefits. As for the stock redemption, while Taxpayer did realize a capital gain, the redemption was undertaken to effect the reorganization by “moving” some of BBC USA’s shareholders from BBC USA to Taxpayer and the evidence in the record suggests that the capital gains were distributed to the “moved” shareholders because the stock’s value appreciated while in their possession. Lastly, Taxpayer’s contribution of the income it earned from the ice cream making operations to BBC USA, without more, is insufficient to prove functional integration since Taxpayer can “add to the riches” of the Business, while maintaining its status as a “discrete business enterprise.” *Allied-Signal*, 504 U.S. at 783. The evidence proffered by the Department, recited above, fails to establish the requisite flow of value, *Allied-Signal*, 504 U.S. at 783, or substantial contribution and dependency, *Louis Dreyfus Corp.*, 933 S.W.2d at 467; consequently, the Department failed to rebut the Taxpayer’s evidence that the two entities were not functionally integrated.

### *Economies of Scale*

In the context of economies of scale, this Court in *Louis Dreyfus Corp.*, *supra.*, asked whether a parent corporation’s provision of “central services” to its subsidiary undermined the subsidiary’s “operational independence.” *Louis Dreyfus Corp.*, 933 S.W.2d at 471. Such “central

services” included staff functions; common operational resources; payment of employees’ salaries, pension plans, benefits packages, and workman’s compensation coverage; legal services; and accounting services. *Id.*

Upon a review of the record, we find there to be no evidence that BBC USA provided any “central services” to Taxpayer which undermined its “operational independence.” In fact, as stated earlier, the Department conceded that “[t]he actual operation of the...ice cream business was *controlled, managed, and conducted* by [Taxpayer’s predecessor] prior to the Reorganization and by [Taxpayer] afterward.” (Emphasis added).

In the absence of any centralized management, functional integration, or economies of scale, we find that BBC USA and Taxpayer were not a unitary business under the “hallmarks of a unitary relationship” test.

## *2. Operational Function Test*

In addition to the “hallmarks of a unitary relationship” test, the United States Supreme Court created the “operational function” test, which acknowledged that “situations could occur in which apportionment might be constitutional even though the ‘payee and the payor [were] not...engaged in the same unitary business,’” *MeadWestvaco Corp.*, 128 S.Ct. at 1507 (quoting *Allied-Signal, Inc.*, 504 U.S. at 787), and that “[w]hat is required instead is that the capital transaction serve an operational rather than an investment function.” *Allied-Signal, Inc.*, 504 U.S. at 787. This test was “not intended to modify the unitary business principle by adding a new ground for apportionment,” but rather it “simply recognize[d] that an asset can be a part of a taxpayer’s unitary business even if...a ‘unitary relationship’ does not exist between the ‘payor and payee.’” *MeadWestvaco Corp.*, 128 S.Ct. at 1507; *Allied-Signal, Inc.*, 504 U.S. at 787 (a “payee and...payor need not be engaged in the same unitary business as a prerequisite to apportionment in all cases”). In explaining this test, the Court offered the following hypothetical:

Hence, for example, a State may include within the apportionable income of a nondomiciliary corporation the interest earned on short-term deposits in a bank located in another State if that income forms part of the working capital of the corporation’s unitary business, notwithstanding the absence of a unitary relationship between the corporation and the bank.

*Allied-Signal, Inc.*, 504 U.S. at 787-88.

In its response in opposition to Taxpayer’s motion for summary judgment, the Department maintained that BBC USA and Taxpayer were unitary under the first test, but nevertheless argued that, if BBC USA and Taxpayer were found not to be unitary, the “income at issue *does* meet the operational function test” because the reorganization was “designed to increase the value of the entire business to stakeholders - value whose ultimate fount is the ice cream operations actually

conducted by [Taxpayer]” and, consequently, that the reorganization was a necessary operational function to Taxpayer’s ice cream making operations.

The undisputed purpose of the stock redemption was to effectuate the reorganization, which required certain BBC USA shareholders, not obtaining an interest in the new S corporation, to be “moved” to Taxpayer. Taxpayer stated, in its response to the Department’s interrogatories, that the capital gains it realized as a result of the stock redemption were distributed to its partners and, in response to the Department’s request for documents, Taxpayer produced a list of those cash distributions. The Second Amended and Restated Plan of Reorganization clearly stated that the redemption was a “taxable event” and that it would “cause *participants in the LP Offering* to pay Federal income tax based on the gain *they* recognize from the Redemption.” (Emphasis added). Lastly, Mr. Rankin, in his affidavit, asserted that “the gain from the stock redemption was allocated to the individual shareholders of BBC USA because the appreciation occurred while the stock was held by the shareholders prior to contribution to [Taxpayer].”

Based upon the above evidence, we find that the capital gains realized by Taxpayer were not used as operational funds, but rather were distributed to Taxpayer’s partners, who were entitled to the earnings since they were in possession of the BBC USA stock at the time it appreciated. While the Department continued to maintain that the reorganization was effected for the purpose of benefitting the entire Business, we find no evidence of such. Instead, the Second Amended and Restated Plan of Reorganization and Taxpayer’s responses to the Department’s Undisputed Statement of Material Facts, interrogatories, depositions, and document requests reveal that the reorganization was done for the purpose of providing tax benefits to BBC USA’s shareholders and avoiding BBC USA’s incurrence of registering and reporting expenses. Consequently, we find that, pursuant to the operational function test, the Department was not constitutionally permitted to assess a tax on Taxpayer’s non-operational earnings.

#### **IV. Conclusion**

Based on our finding that the Department’s tax assessment was unconstitutional, the issue regarding the classification of Taxpayer’s earnings as “business earnings” has been rendered moot.

For the reasons set forth above, the decision of the Chancery Court is AFFIRMED. Costs are assessed against the Department, for which execution may issue if necessary.

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RICHARD H. DINKINS, JUDGE